

Day Break

Friday, 23 September 2016

Company Update

Pakistan State Oil Co. Ltd.

Oil & Gas Marketing Companies

Recommendation	BUY
Target Price	507.9
Last Closing	413.6
Upside	23%

Market Data

Bloomberg Tkr.	PSO PA
Shares (mn)	271.7
Market Cap (PKRbn USDmn)	112.4 1,073.1
Exchange	KSE 100

Price Info.	90D	180D	365D
Abs. Return	5.1	16.5	40.0
Low	366.9	347.5	287.0
High	420.9	420.9	420.9

Key Company Financials

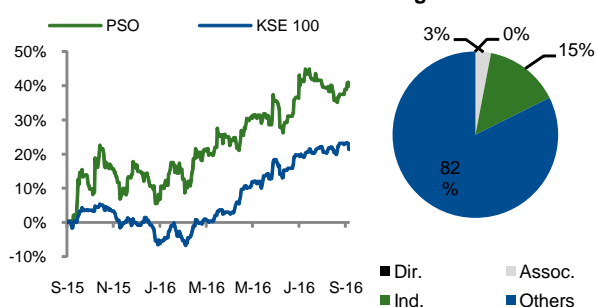
Period End: Jun

PKRbn	FY15A	FY16A	FY17F	FY18F
Total Revenue	913.1	678.0	832.5	933.7
Net Income	6.9	10.3	17.4	18.4
EPS (PKR)	25.5	37.8	64.1	67.8
DPS (PKR)	10.0	12.5	21.0	22.0
Total Assets	341.3	354.8	391.8	414.0
Total Equity	82.3	89.2	100.9	113.3

Key Financial Ratios

ROE (%)	8%	12%	17%	16%
P/E (x)	16.2	10.9	6.5	6.1
P/B (x)	1.4	1.3	1.1	1.0
DY (%)	2.4	3.0	5.1	5.3

Relative Price Performance & Shareholding



About the Company

Pakistan State Oil was incorporated in Pakistan in 1976. The principal activities of the Company are procurement, storage and marketing of petroleum and related products. It also blends and markets various kinds of lubricating oils.

Source: Bloomberg, KSE 100 & IGI Research

Analyst

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Pakistan State Oil Co. Ltd Revised Earnings Estimates; CPI Linked Margins and Increased Retail Product Demand, To Propel Earnings Growth

Investment Case

We have revised our Target Price for Pakistan State Oil (PSO) to PKR 508/share from previous PKR 448/share based on expected a) increase in PSO market share for Motor Sprit (MS) and High-Speed Diesel (HSD) volumes during FY17-FY20 and, b) annual margin accretion for MS and HSD post linking with CPI inflation.

Sales Assumption revised on the back of Higher Demand

We have revised upward our MS and HSD sales volumes for PSO by +15/ 17/ 20% and +1/ 1/ 1% for FY17/ 18/ 19F, respectively reaching 4.2mnTon for MS and 4.5mnton for HSD by FY19F. This leads to incremental earnings of PKR 3.7/ 5.1/ 7.5/share (up by +6 / 8/ 10%) in FY17/ 18/ 19F respectively.

Margin increase Linked with CPI from FY18 onwards

We estimate, rise in MS margins from base margin of PKR 2.35/ltr to contribute PKR 0.67/share to FY17F earnings, while HSD is anticipated to contribute PKR 0.75/share (PKR 2.35/ltr base margin in FY16). As a result of margin accretion, incremental earnings are projected to increase by +5/ 10% in FY18/ 19F from its base margin of PKR 2.41/share in FY17F for both MS and HSD.

Earnings to post 3yr CAGR of +28% during FY17-FY19F

Along with higher MS and HSD volumetric growth and annual margin revision, we expect company to book lower inventory losses due to expected recovery in oil prices and recovery in FO prices, the company will be able to compensate for loss of LNG income (once LNG contract is shifted to Pakistan LNG from PSO). As a result, we now expect the company's earnings to post 3yr CAGR of +28% (FY17-FY19F).

Earnings up by +48%YoY in FY16 to PKR 37.81/share

PSO registered +48%YoY growth in earnings in FY16 to PKR 10.3bn (EPS PKR 37.81) as compared to PKR 6.9bn (EPS PKR 25.53) in the same period last year. This accretion in earnings is attributable to a) +30%YoY/+7%YoY jump in MS/HSD volumes, lower inventory losses and, c) 35%YoY drop in finance cost to PKR 7.2bn owing to lower interest rates. The company announced cash dividend of PKR 7.5/share in 4QFY16 taking total FY16 dividend to PKR 12.5/share.

Valuation and Recommendation

Valuation

We have revised our Target Price for Pakistan State Oil (PSO) to PKR 508/share from previous PKR 448/share (up by +13%). We have used discounted cash flow (DCF) method to value the company. We have used, 6.25% as a risk free rate, risk premium at 6.50%, and 3yr beta of 1.2, bringing cost of equity at 10.5%.

Recommendation

The scrip is currently trading at FY17F P/E of 6.5x. With our Dec-16 target price of PKR 508/share, the scrip offers +23% upside from its last closing price of PKR 413/share, hence we recommend a **'BUY'** call on PSO.

Valuation Parameters

Risk Free Rate	6.25%
Beta	1.22
Risk Premium	6.50%
Cost of Equity	13.40%
Cost of Debt	8.50%
Cost of Debt (after Tax)	6.30%
WACC	10.54%
Sustainable Growth Rate	3.00%

Discounted Cash Flows	Jun-16	Jun-17	Jun-18	Jun-19	Jun-20
PKRmn					
EBIT	22,826	31,914	32,587	37,426	41,862
EBIT (1-t)	14,878	22,077	22,869	26,265	29,377
+ Depreciation	1,014	1,072	1,140	1,183	1,227
- CAPEX	(1,298)	(1,588)	(1,093)	(1,098)	(1,103)
- WC	15,371	16,954	(6,768)	(8,843)	(7,508)
FCFF	29,965	38,515	16,148	17,507	21,994

Sum of PV FCFF	237,761
Net Debt	(99,764)
Enterprise Value	137,586
No. of Shares	271.69

Target Price (PKR) – Dec-16	507.9
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MS and HSD to drive volumetric growth

Sales Assumption revised on the back of Higher Demand

MS and HSD volumes have registered nearly +30% and +7% growth respectively in FY16. This was primarily led by lower domestic oil prices and higher robust automobile growth. Going forward we expect domestic oil prices to stay depressed along with healthy automobile sales, FY17-19. We have assumed international oil prices (Arab Light) to range in between USD 45-50/bbl, while our long-term prices assumption stays intact at USD 50/bbl.

PSO being the market leader and direct beneficiary of OMC growth, we have revised up PSO, MS and HSD sales volumes by +15/ 17/ 20% and +1/ 1/ 1% for FY17/ 18/ 19F, respectively. As result, volumes for MS and HSD will reach 4.2mnton and 4.5mnton by FY19F, from current (FY16) 2.9mnton and 3.9mnton respectively. In absolute terms that's nearly +44% and +13% growth in MS and HSD, respectively. This will bring about incremental earnings of PKR 3.7/ 5.1/ 7.5/share (up by +6 / 8/ 10%) in FY17/ 18/ 19F respectively.

Exhibit: PSO Total Volumes to grow at a 3 years CAGR of 5% from FY16-FY19F (mnTon)

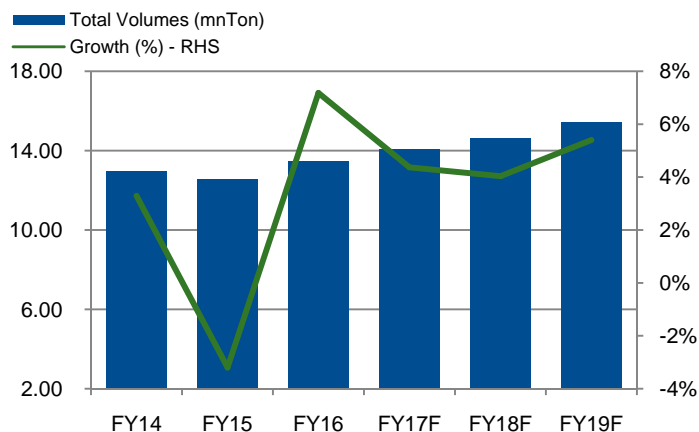


Exhibit: MS, HSD and FO Volumes from FY16-FY19F (mnTon)

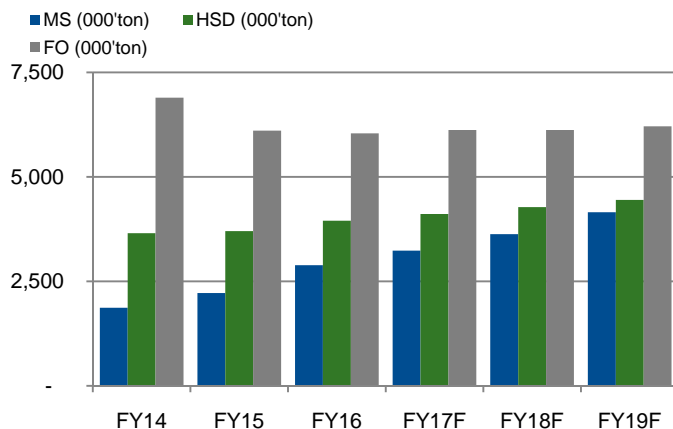


Exhibit: Earnings to post 3yr CAGR of 28% from FY16-FY19F

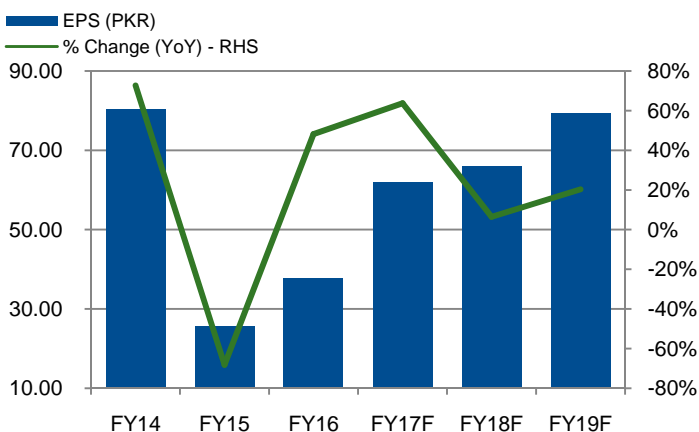
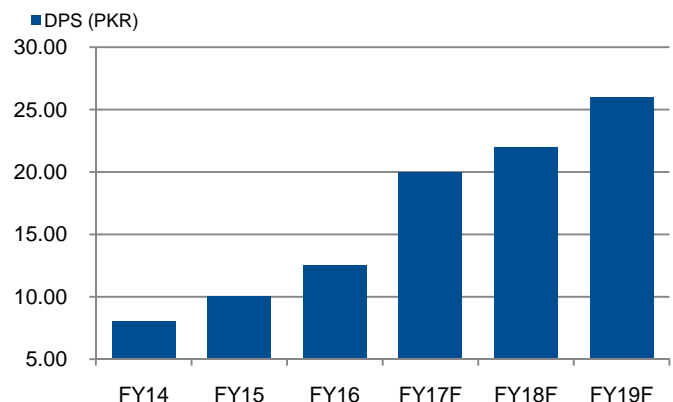


Exhibit: Dividend Payout to remain in line with previous as circular debt still remains unresolved



Source: IGI Research, Company's Financials

PSO to regain market share through expanding retail outlets and adding storage facility

PSO's management expressed its plans to regain its current ailing market share in MS and HSD through expansion in retail outlets and enhancing its storage capacity for efficient supply chain management. The company incurred capital expenditure of PKR 1.3bn in FY16 and intends to incur further capital expenditure in FY17 for similar purpose. The company plans to add 100 retail outlets per annum, from its current >3,500 outlets. As a result of management aggressive take on market share, we estimate PSO's market share in MS/HSD to reach 52%/56% by FY19 from 47%/50% in FY15.

Exhibit: MS market share Comparison of PSO against its peers

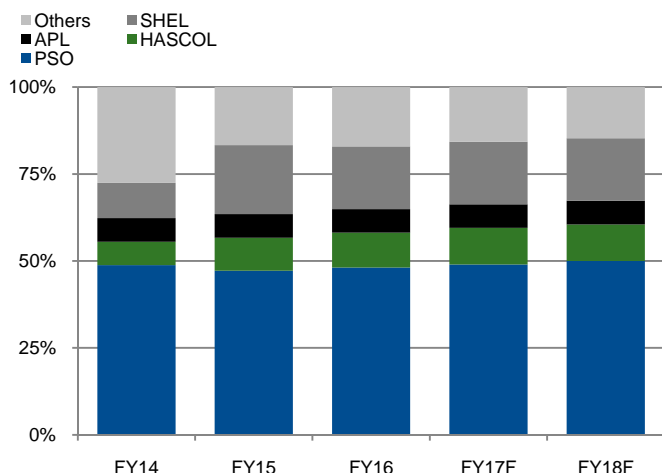
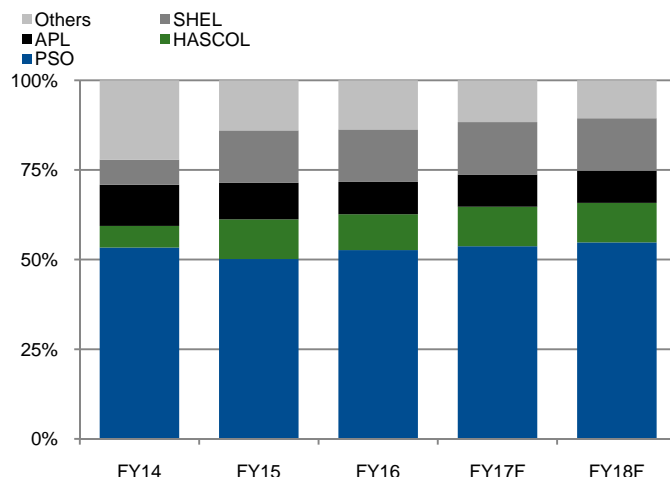


Exhibit: HSD market share Comparison of PSO against its peers



Source: IGI Research, Company's Financials

OMC margins linked with CPI inflation

ECC approved annual margin increase with CPI

In May-16, the Economic Coordination Committee (ECC) approved on recommendation of Ministry of Petroleum and Natural Resources (MPNR) annual increase of 0.06/ltr in OMCs margins for MS and HSD, along with annual revision thereon linked with CPI. These revised margins were effective from Jul-16. To recall, the last increase in margins was granted back in Nov-14, increasing MS and HSD margins by +5% (PKR 0.57/ltr) and +32% (PKR 0.11/ltr) to PKR 2.35/ltr, respectively.

Taking a 5% base case increase in CPI, we estimate MS and HSD margins to augment by 5%YoY from FY18F onwards. MS and HSD margins are expected to clock in at PKR 2.53/share/PKR 2.66/share/PKR 2.79/share for FY18/FY19/FY20, respectively.

Annual Margin increase to lift earnings by +2% in FY17F

For PSO we estimate, rise in MS margins from base margin of PKR 2.35/ltr to contribute PKR 0.67/share to FY17F earnings, while HSD is anticipated to contribute PKR 0.75/share (PKR 2.35/ltr base margin in FY16). As a result of margin accretion, incremental earnings are projected to increase by +5/ 10% in FY18/ 19F from its base margin of PKR 2.41/share in FY17F for both MS and HSD.

Exhibit: MS and HSD Margin increase linked with CPI

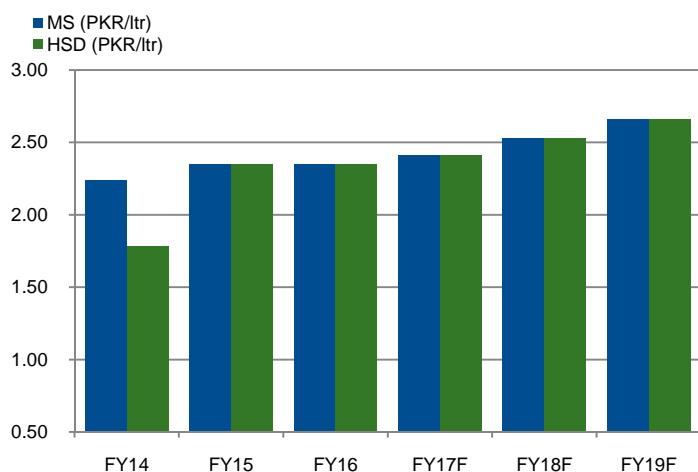
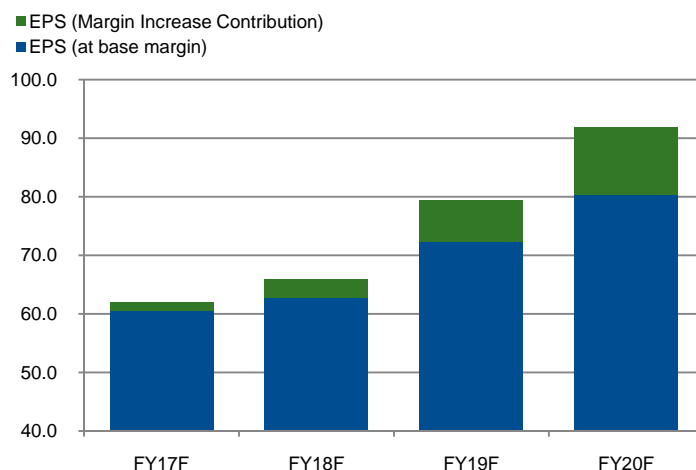


Exhibit: Earnings Contribution of Margin up lift from base margin of PKR 2.35/ltr in FY17 and PKR 2.41/ltr there onwards



Source: IGI Research, Company's Financials

FO profit contribution to augment as prices recover

FO prices making new lows...

International FO price (180cst bunker fuel Singapore) declined by 49%YoY in FY16 averaging USD219/MT. As a result of this steep slump in international price, domestic FO prices came down by 42%YoY in FY16 averaging PKR 33,077/MT. Local FO price bottomed out in Feb-16 posting a low of PKR 22,465/MT.

...however prices have recovered after bottoming out in Feb-16

Since, Feb-16 FO prices have recovered nearly +84% to current PKR 41,270/Mt, but still remain at a discount of 48% from its peak level of PKR 85,101/MT back in Apr-12.

Amid price recovery, we expect FO profit contribution to increase by +14%YoY in FY17 to PKR 7.9bn. Moreover, improved profit contribution from FO should compensate for loss in income from LNG business as Government plans to shift LNG contract from PSO to a newly formed company, Pakistan LNG. Although there has been no official notification of this but the management believes that the contract is expected to be shifted to Pakistan LNG by Dec-16. We have excluded income from LNG business from 2HFY17 onwards.

Exhibit: FO Prices after bottoming out in FY16 have started to recover in FY17 but still remain well below peak price in FY14

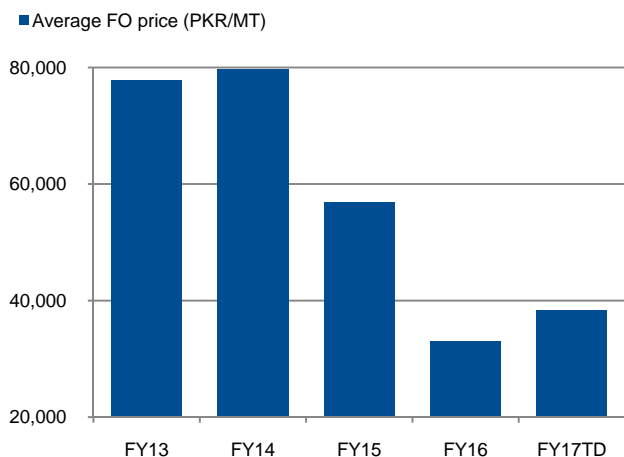
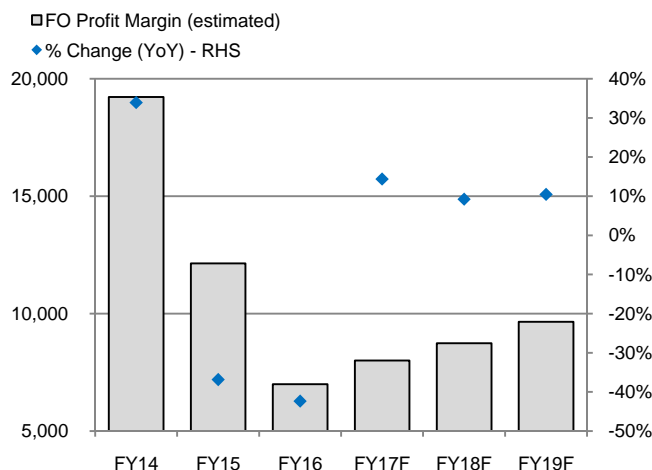


Exhibit: FO profit contribution to increase by 14%YoY in FY17 as prices recover after bottoming out in Feb-16



Source: IGI Research, Company's Financials

Key Catalyst

- **Limited accumulation in circular debt:** According to the management, the company has received payments of PKR 293bn against PKR 308bn receivables created since Jan-15. However, the company has not received payments for the amount accumulated before that period resulting in net receivables of PKR 185bn at the end of FY16. Once these outstanding payments are received, better cash position will likely lead to better payout in our view.
- **Minimum inventory losses:** The company posted inventory loss of nearly PKR 7.8bn (PKR 28/share) and PKR 7.9bn (PKR 29/share) as oil prices dropped by ~44% and 33% in FY16 and FY15 respectively. Going forward we believe overall inventory losses to minimize, as oil price show recovery.

Key Risk

- **LNG - shifting contract to newly formed company:** The company's management mentioned that Government in its letter to the company expressed its intention to shift the LNG contract of PSO to a newly formed company, Pakistan LNG by the end of Dec-16. As per the PSO management, there hasn't been any official announcement confirming shifting of contract. Nevertheless, even with transfer of LNG contract to Pakistan LNG; PSO's earnings are expected to contract by mere 6%-7%, which will likely be mitigated through recent recovery in FO prices combined with improved FO volumes.

Financials

Pakistan State Oil (PSO)

Current Price (PKR):	413.6		Target Price (PKR):		507.9	Upside	23%		Recommendation		BUY
Jun-end	FY15A	FY16A *	FY17F	FY18F	FY19F	Jun-end	FY15A	FY16A *	FY17F	FY18F	FY19F
Income Statement Items (PKRmn)						Valuation Ratios					
Gross Sales	1,114,411	906,204	1,147,334	1,166,144	1,315,352	EPS (PKR)	25.5	37.8	64.1	67.8	81.4
Net Sales	913,094	677,967	832,480	933,737	1,059,927	DPS (PKR)	10.0	12.5	21.0	22.0	27.0
Gross Profit	23,579	22,863	33,751	36,736	41,572	BVPS (PKR)	303.0	328.3	371.3	417.2	471.6
Admin and Selling Exp	11,419	12,835	12,527	13,226	13,942	P/E (x)	16.2	10.9	6.5	6.1	5.1
Other Income	14,024	12,798	14,379	12,692	13,231	D/Y (%)	2.4	3.0	5.1	5.3	6.5
EBIT	22,671	22,826	31,914	32,587	37,426	P/B (x)	1.4	1.3	1.1	1.0	0.9
Depreciation	900	952	1,007	1,070	1,111	Earnings Growth (%)	(68.2)	48.1	69.4	5.9	20.0
Finance Cost	11,017	7,150	7,250	6,846	6,418	ROE (%)	8.6	12.0	18.3	17.2	18.3
Pre-tax Profits	12,034	16,289	25,160	26,260	31,517	ROA (%)	1.9	3.0	4.7	4.6	5.2
Post- Tax Profits	6,936	10,273	17,405	18,429	22,118	Price/cash	48.6	39.0	19.4	20.3	23.0
Balance Sheet Items (PKRmn)						Margins					
PPE	6,333	6,617	7,133	7,086	7,000	Gross Margins (%)	2.6	3.4	4.1	3.9	3.9
Non-Current Assets	65,559	61,929	61,937	61,900	61,825	EBITDA Margins (%)	2.6	3.5	4.0	3.6	3.6
Stock-in-Trade	58,492	48,460	61,272	68,811	78,120	Net Profit Margins (%)	0.8	1.5	2.1	2.0	2.1
Trade Debts	180,778	206,351	228,077	243,027	261,352	Financial Gearing					
Current Assets	275,749	292,890	329,859	352,074	379,538	Total Debt / Equity (%)	124.0	85.6	49.7	38.6	28.6
Total Assets	341,307	354,819	391,796	413,974	441,364	Interest Coverage	2.1	3.2	4.4	4.8	5.8
Non-Current Liabilities	8,321	8,737	9,174	9,632	10,114	Efficiency Ratios					
Trade Payables	147,045	179,007	230,037	245,754	265,051	Current Ratio	1.1	1.1	1.2	1.2	1.3
Current Liabilities	250,676	256,895	281,735	291,003	303,129	Quick Ratio	0.9	1.0	1.0	1.0	1.0
Total Liabilities	258,997	265,632	290,909	300,635	313,243	Macro- Assumption					
Share capital	2,717	2,717	2,717	2,717	2,717	Oil (USD/bbl.)	72.53	40.66	45.00	50.00	50.00
Total equity	82,310	89,187	100,887	113,339	128,121	PKR/USD	101.40	104.30	107.57	110.80	114.13
Cash Flow Items (PKRmn)						Volumes (mnTon)					
Operating CF	(20,049)	26,658	35,431	12,801	14,458	MS	2.22	2.89	3.23	3.63	4.15
Investing CF	(4,752)	3,032	(644)	(644)	(627)	HSD	3.70	3.95	4.11	4.28	4.45
Financing CF	7,038	(29,122)	(31,878)	(12,409)	(14,491)	FO	6.11	6.04	6.12	6.12	6.21
Closing Cash	2,312	2,880	5,789	5,536	4,877	Total	12.56	13.47	14.05	14.62	15.41

Source: IGI Research, Company Financials

About the Company

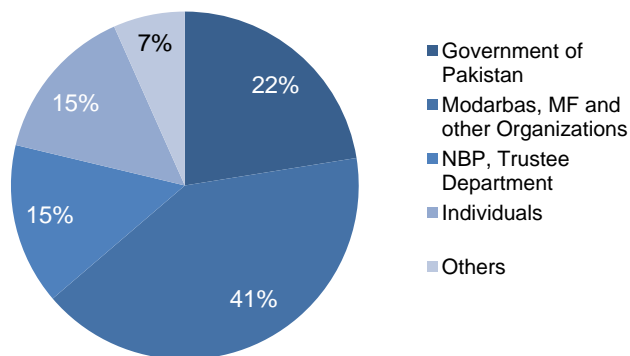
Pakistan State Oil was incorporated in Pakistan in 1976 and it is listed on Karachi, Lahore and Islamabad Stock Exchanges. The registered office of the Company is located at PSO House, Karachi. The principal activities of the Company are procurement, storage and marketing of petroleum and related products. It also blends and markets various kinds of lubricating oils.

Background

- Involved in marketing and distribution of Motor Gasoline (Mogas), High Speed Diesel (HSD), Furnace Oil (FO), Jet Fuel (JP-1), Kerosene, CNG, LPG, Petrochemicals and Lubricants.
- Company has largest storage capacity representing 68% of the country's total storage capacity.
- The company has more than 3500 retail outlets.
- PSO is the major fuel supplier to aviation, railways, power projects, armed forces, marine and agriculture sectors.
- The company currently holds LNG supply contract of 3.75mnTon with Qatar Gas for a period of 15 years.

Shareholding Pattern

Exhibit: Shareholding Pattern



Source: IGI Research, Company's Financials

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Recommendation	Rating System
Buy	If target price on aforementioned security(ies) is more than 10%, from its last closing price(s)
Hold	If target price on aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
Sell	If target price on aforementioned security(ies) is more than -10%, from its last closing price(s)

Time Horizon: Dec - 2016

Valuation Methodology: The analyst(s) has used following valuation methodology to arrive at the target price of the said security (ies):

DCF (Discounted Cash Flow)

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